Report

of the

Examination of

Capitol Indemnity Corporation

Madison, Wisconsin

As of December 31, 2001

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State of Wisconsin / OFFICE OF THE COMMISSIONER OF INSURANCE

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Jorge Gomez, *Commissioner*

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April 7, 2003

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Commissioners:

In accordance with your instructions, a compliance examination has been made of the affairs and financial condition of:

CAPITOL INDEMNITY CORPORATION
Madison, Wisconsin

and this report is respectfully submitted.

I. INTRODUCTION

The previous examination of the company was conducted in 1997 and 1998 as of December 31, 1996. The current examination covered the intervening period ending December 31, 2001, and included a review of such 2002 transactions as deemed necessary to complete the examination.

The examination consisted of a review of all major phases of the company's operations, and included the following areas:

History
Management and Control
Corporate Records
Conflict of Interest
Fidelity Bonds and Other Insurance
Employees' Welfare and Pension Plans
Territory and Plan of Operations
Affiliated Companies
Growth of Company
Reinsurance
Financial Statements
Accounts and Records
Data Processing

Emphasis was placed on the audit of those areas of the company's operations accorded a high priority by the examiner-in-charge when planning the examination. Special attention was given to the action taken by the company to satisfy the recommendations and comments made in the previous examination report.

The section of this report titled "Summary of Examination Results" contains comments and elaboration on those areas where adverse findings were noted or where unusual situations existed. Comment on the remaining areas of the company's operations is contained in the examination work papers.

The company is annually audited by an independent public accounting firm as prescribed by s. Ins 50.05, Wis. Adm. Code. An integral part of this compliance examination was the review of the independent accountant's work papers. Based on the results of the review of these work papers, alternative or additional examination steps deemed necessary for the completion of this examination were performed. The examination work papers contain documentation with respect to the alternative or additional examination steps performed during the course of the examination.

Independent Actuary's Review

Independent actuaries were engaged under a contract with the Office of the Commissioner of Insurance. They reviewed the adequacy of the company's loss reserves and loss adjustment expense reserves. The results of their work were reported to the examiner-in-charge. As deemed appropriate, reference is made in this report to the actuaries' conclusion.

II. HISTORY AND PLAN OF OPERATION

The company was organized on September 23, 1959, as Capitol Indemnity Corporation (hereinafter also “CIC” or “the company”) and commenced business on June 6, 1960. The company is 100% owned by Capitol Transamerica Corporation (hereinafter “CTC”), a Wisconsin holding company, which was organized in 1965.

Effective January 4, 2002, Alleghany Corporation (hereinafter also “Alleghany”) announced the closing of a merger agreement under which Alleghany purchased CTC for approximately $182 million in cash. Prior to the purchase CTC was a publicly traded company whose common stock was traded through the National Association of Securities Dealers. For additional information related to affiliates see the section of this report titled “Affiliated Companies”. Additional information regarding the purchase by Alleghany is discussed in the section of this report titled “Appendix-Subsequent Events”.

CIC markets business through both independent and general insurance agents, referred to as regional agents by the company. Agents do not have claim adjusting authority nor do they have any authority to transact reinsurance on behalf of the company. The relationships with the agents tend to be generally long with approximately 85% of agents having conducted business with CIC for over five years. Contingency contracts are utilized with qualification being based on profitable ultimate loss ratios , subject to minimum production standards.

CIC offers a complete portfolio of specialty commercial property and casualty coverages, fidelity and surety bonds. The property, casualty and workers’ compensation segments account for approximately 83% of CIC’s premiums written, while fidelity and surety represents the remaining 17%. CIC offers workers’ compensation insurance only in Wisconsin, Illinois, and Iowa.

In 2001, the company wrote business in all 36 jurisdictions in which it was licensed and also wrote on a surplus-lines basis in Georgia. The distribution of direct premiums written in 2001 by state is as follows:

Wisconsin	$23,467,148	18.7%
Illinois	17,910,388	14.3
Minnesota	8,016,832	6.4
Pennsylvania	6,603,441	5.3
Missouri	5,971,274	4.8
Nevada	5,571,113	4.5
All other	57,566,699	46.0
Total	$125,106,895	100.0%

As of the examination date, the company was licensed in the following 36 states:

Alabama*	Louisiana	Oklahoma
Arizona	Maryland*	Oregon
Arkansas	Michigan	Pennsylvania
Colorado	Minnesota	South Carolina*
Delaware	Mississippi	South Dakota
Florida	Missouri	Tennessee*
Idaho	Montana	Texas
Illinois	Nebraska	Utah
Indiana	Nevada	Virginia
Iowa	New Mexico	Washington
Kansas	North Dakota	Wisconsin
Kentucky	Ohio	Wyoming

* - Indicates license acquired since the last examination.

In the state of Wisconsin, the company is licensed to transact all lines of property and casualty business as defined by s. Ins 6.75 (2), Wis. Adm. Code, except title, mortgage guaranty, credit, legal expense, and credit unemployment.

The following table is a summary of the net insurance premiums written by the company in 2001. The growth of the company is discussed in the Financial Data section of this report.

Line of Business	Direct Premium	Reinsurance Assumed	Reinsurance Ceded	Net Premium
Fire	$ 272,224	$	$ 7,879	$ 264,345
Allied lines	140,694		3,898	136,796
Commercial multiple peril	82,859,398	89,589	7,892,971	75,056,016
Inland marine	1,171,358		819,586	351,772
Other accident and health	290,413	2,752,727	2,752,727	290,413
Workers' compensation	7,239,886		137,241	7,102,645
Other liability - occurrence	11,369,056		630,266	10,738,790
Products liability - occurrence	649,878			649,878
Fidelity	1,452,829		148,786	1,304,043
Surety	19,634,310		3,211,209	16,423,101
Burglary and theft	26,849			26,849
Total All Lines	$125,106,895	$2,842,316	$15,604,563	$112,344,648

III. MANAGEMENT AND CONTROL

Board of Directors

The board of directors consists of five members who are elected annually. Officers are elected at the board's annual meeting. Members of the company's board of directors may also be members of other boards of directors in the holding company group. Inside board members receive no additional compensation for their service. Outside board members receive an annual board retainer of $15,000, an annual committee chairman retainer of $3,000, and a $650 per meeting fee for service on all boards within the Alleghany Insurance Holdings Group.

Currently the board of directors consists of the following persons:

Name and Residence	Principal Occupation	Term Expires
Paul J. Breitnauer DeForest, WI	President and Chief Executive Officer – Capitol Indemnity Corp.	2003
Dorthea C. Gilliam Hinsdale, IL	President Alleghany Consulting Inc.	2003
Richard N. Latzer Hillsborough, CA	Former Director of Transamerica Investment Services, Inc.	2003
David F. Pauly Madison, WI	Chief Operating Officer Capitol Indemnity Corp.	2003
James P. Slattery New Canaan, CT	Officer Alleghany Corporation	2003

Officers of the Company

The officers appointed by the board of directors and serving at the time of this examination are listed below. Listed compensation is total gross earnings for services rendered the Alleghany Insurance Holdings Group.

Name	Office	2002 Compensation
James P. Slattery	Chair of the Board	*
Paul J. Breitnaurer	President and Chief Executive Officer	$402,577
David F. Pauly	Executive Vice President, Chief Operating Officer, and Secretary	296,573
Thomas K. Manion	Vice President, Treasurer, Chief Financial Officer, and Assistant Secretary	233,186
John J. Burns, Jr.	Vice President	*
Richard W. Allen	Vice President – Non-Contract Surety Business	178,882
Edward H. Halloran	Vice President – Underwriting	134,773
Kent R. Lawson	Vice President – Property & Casualty	96,212
Robert F. Miller	Vice President – Claims	103,951
James C. Schlacks	Vice President – Marketing	96,577
Diane West	Vice President – Human Resources	46,693
James W. Smirz	Vice President – Fidelity & Surety Claims and Assistant Secretary	144,581
Frank S. Zillner	Vice President – Information Systems	165,359

* - No compensation is allocated to the company for these salaries

Committees of the Board

The company's bylaws allow for the formation of certain committees by the board of directors. The committees at the time of the examination are listed below:

Executive Committee
James P. Slattery, Chair
Dorthea C. Gilliam
David F. Pauly

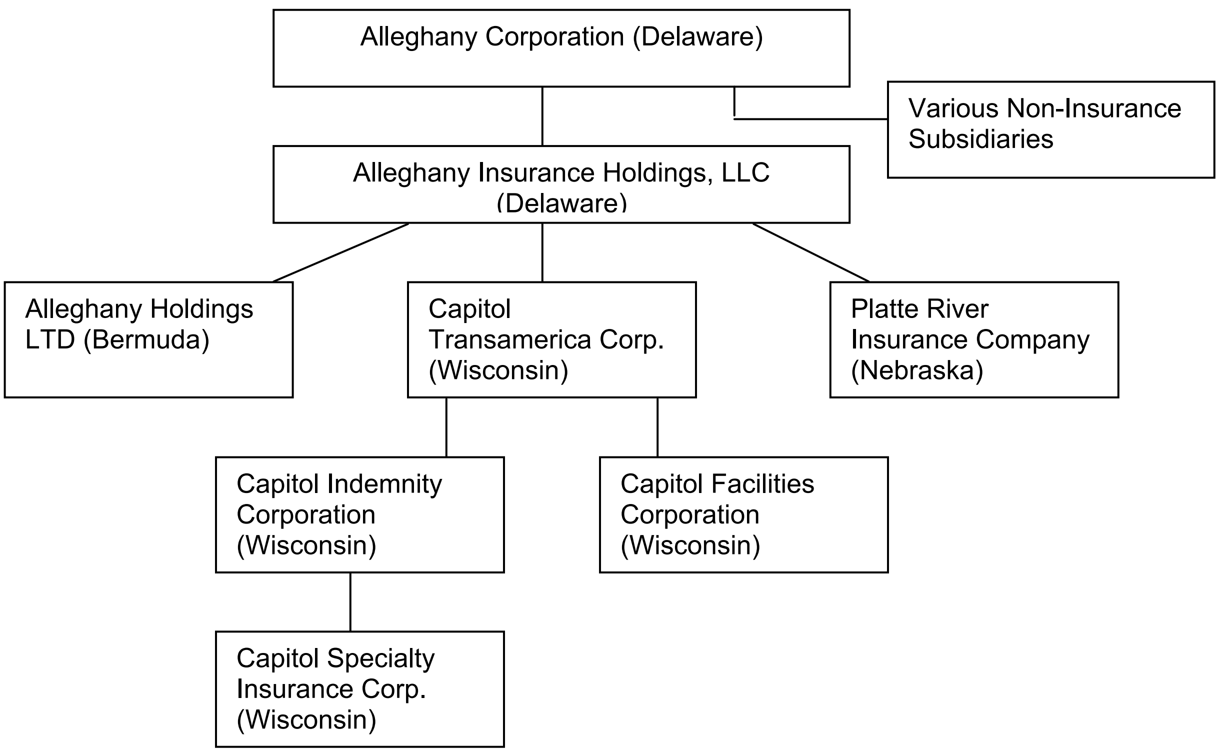
Investment Committee
Richard N. Latzer, Chair
Dorthea C. Gilliam, Vice Chair
James P. Slattery
Thomas K. Manion, Secretary

IV. AFFILIATED COMPANIES

As noted earlier, effective January 4, 2002, Alleghany Corporation (hereinafter "Alleghany") announced the closing of a merger agreement under which Alleghany purchased CTC for approximately $182 million in cash. Due to the timing of this change, the following discussion of affiliates will present the relationship as of March 31, 2002. For additional information related to this change in control, see the section of this report titled "Appendix-Subsequent Events."

Capitol Indemnity Corporation is a member of a holding company system. The organizational chart below depicts the relationships among the affiliates in the group. A brief description of the significant affiliates follows the organizational chart.

Organizational Chart
March 31, 2002



Alleghany Corporation

Alleghany, a Delaware holding company, was incorporated as a business corporation in 1986 under the laws of the state of Delaware. The Delaware corporation succeeded the original Alleghany Corporation, a Maryland corporation, which was incorporated in 1929. Alleghany is engaged in the industrial minerals business through its subsidiaries, World Minerals Inc., Celite Corporation and Harborlite Corporation. Alleghany conducts a steel fastener importing and distribution business through its subsidiary, Heads & Threads International LLC. Alleghany is also engaged in property, casualty, fidelity and surety insurance businesses through its indirect subsidiaries, Capitol Transamerica Corporation and Platte River Insurance Company. In addition, through another subsidiary, Alleghany Properties, Inc., Alleghany owns and manages properties in California.

As of December 31, 2001, Alleghany's audited financial statement reported assets of \$1,875,005,000, liabilities of \$484,423,000, and stockholder equity of \$1,390,582,000. Operations for 2001 produced net earnings of \$224,230,000.

Alleghany Insurance Holdings LLC

Alleghany Insurance Holdings LLC (hereinafter "AIHL") is a wholly owned subsidiary of Alleghany Corporation. AIHL was formed in 2000 in the state of Delaware. AIHL is intended to function as the holding company for all insurance operations for Alleghany. AIHL operations include run-off operating activities from insurance entities previously owned by Alleghany.

As of December 31, 2001, the company's financial statement reported assets of \$142,956,000, liabilities of \$(172,010,000) and stockholder equity of \$314,966,000. Operations for 2001 produced net loss of \$234,340,000, which includes a loss on discontinued operations of \$201,267,000.

Capitol Transamerica Corporation

Capitol Transamerica Corporation (hereinafter "CTC") is a wholly owned subsidiary of Alleghany Insurance Holdings, Inc. CTC was organized in 1965 for the purpose of acquiring the outstanding stock of CIC and Capitol Specialty Insurance Corporation. Prior to its purchase by Alleghany, CTC was a publicly traded company through the National Association of Securities Dealers under the symbol "CATA". CTC was responsible for legal and other corporate expenses prior to the Alleghany transaction. Its sources of revenue are investment income, dividend income from subsidiaries, and fee income charged to subsidiaries. The fee income relates to charges for usage of depreciable assets and for rental space. CTC owns all depreciable assets within the Capitol family of companies and is also the named tenant for office space leased. It charges the related companies monthly fees for usage of such assets and space based on estimated actual usage by the various individual companies.

As of December 31, 2001, the company's audited financial statement reported assets of $144,182,657, liabilities of $2,330,481, and unassigned funds and special reserves of $141,852,176. Operations for 2001 produced net loss of $13,153,883.

Capitol Facilities Corporation

Capitol Facilities Corporation (hereinafter “CFC”) is a wholly owned subsidiary of Capitol Transamerica Corporation. CFC historically facilitated premium-financing opportunities for its affiliated insurance entities. With the implementation of a direct billing program by its insurance affiliates in 1998-1999, such arrangements were generally no longer necessary. Therefore, operational activity for CFC is currently limited. Steps are being taken to license CFC as a general agent to potentially facilitate future relationships with other insurance companies offering products not provided by Capitol but desired by its policyholders. Additionally, a licensing initiative is occurring for CFC, which will allow it to collect and pay out premium trust funds on behalf of its affiliated insurance entities in the future.

As of December 31, 2001, the company's unaudited financial statement reported assets of $39,341, liabilities of $0, and unassigned funds and special reserves of $39,341. Operations for 2001 produced net loss of $1,117.

Platte River Insurance Company

Platte River Insurance Company (hereinafter “Platte River”), formerly known as Underwriters Insurance Company, was incorporated on January 6, 1972, and commenced business on January 14, 1972. It is domiciled in Nebraska. Effective January 3, 2002, Platte River became an affiliate of Capitol Indemnity when it was purchased by Alleghany for approximately $40 million and subsequently changed its name to the one currently used. The seller contractually retained all of the liabilities of Platte River that existed at the time of the sale.

Effective January 1, 2002, Platte River has a 10% net retention in the affiliated pooling agreement with CIC, whereby after cessions to unaffiliated reinsurers, all business written or assumed on a going forward basis is combined and reapportioned. For additional information related to the affiliated pooling agreement see the section of this report titled “Reinsurance”. For additional information related to the purchase by Alleghany and other changes to the holding company structure, see the section of this report titled “Appendix-Subsequent Events”.

As of December 31, 2001, the company's statutory annual statement reported assets of $33,016,072, liabilities of $501,876, and unassigned funds and special reserves of $32,514,196. Operations for 2001 produced net income of $2,635,203.

Capitol Specialty Insurance Corporation

Capitol Specialty Insurance Corporation (hereinafter “CSIC”) is a Wisconsin stock insurance company writing property and casualty coverages. Prior to March 31, 2002, CSIC was a wholly owned subsidiary of CTC. Effective January 4, 2002, the Alleghany Corporation acquired CTC (the company’s ultimate parent at the time) and its subsidiaries, including CSIC. Effective March 31, 2002, CTC contributed the capital stock of CSIC to Capitol Indemnity. CSIC has not written any business in recent years, but with an additional capital contribution of $11.7 million in 2001 by CTC, it is being positioned to begin writing business in the future. Absent any amendment, CSIC would cede 100% of any business written to Capitol Indemnity under a reinsurance agreement that has been in effect since August 1, 1997.

As of December 31, 2001, the company's statutory annual statement reported assets of $16,301,018, liabilities of $447,067, and unassigned funds and special reserves of $15,853,951. Operations for 2001 produced a net loss of $(141,153).

Affiliated Agreements

In accordance with an administrative service agreement with CTC, “Capitol Indemnity agrees to provide, or cause to be provided, during the life of this agreement, resource to a staff of experts, especially trained, and of acknowledged proficiency in their respective fields, who shall be available, or be caused to be available, to render services to the company in marketing and sales, accounting, personnel, data processing and systems, legal and tax matters, underwriting and reinsurance, and claims.” Through the agreement, Capitol Indemnity prepares and distributes

CTC's reports, including payment for any services by independent agencies, travel and reimbursement expenses of directors, and all directors' fees of the company. CTC agrees to pay Capitol Indemnity monthly reimbursements of $10,000 for such general and special services rendered and expenses borne by Capitol Indemnity. Similar agreements have been in effect since 1977, with the latest amendment being effective on January 1, 2002, in which the reimbursement was reduced to $2,500, as some services were eliminated as CTC is no longer publicly traded.

Similar to the administrative service agreement with CTC, Capitol Indemnity provides administrative services to CSIC, through an agreement between CTC and CSIC. Effective January 1, 2002, Capitol Indemnity receives $20,000 monthly in consideration for these services.

Investment counseling services are provided to the company through an investment advisory and custodial service agreement with the parent. An appointed designee acts as custodian for invested assets and collects income from such invested assets. There is no compensation paid for this investment advisory agreement. During 2002, several third party investment advisors were hired to provide investment advice for specific segments of the company's investments.

An equipment service agreement with CTC allows company usage of all office equipment and furniture, data processing equipment, and vehicles. Compensation for equipment usage is $61,600 a month.

A rental service agreement is in place with CTC. The parent leases certain square footage of the building they occupy, along with the company, from an outside party. In turn, CTC charges the company rent of $61,000 a month.

An administrative service agreement between Capitol Indemnity and CFC is in effect that provides CFC with personnel for marketing, accounting, data processing and legal matters. Reimbursement for these services is at the rate of $300 per month.

Effective January 4, 2002, Capitol Indemnity entered into a service agreement with Platte River to provide essential facilities and services to facilitate Platte River's insurance operations including record keeping and general administrative services. Compensation is consistent with the terms of the affiliated pooling agreement in which Platte River receives a 10% net retention of the pooled business.

Capitol Indemnity is party to a consolidated federal tax agreement with certain affiliates, whereby it files its federal income tax on a consolidated basis with CTC. Effective on January 1, 2002, a new tax sharing agreement was executed to file on a consolidated basis with Alleghany.

V. REINSURANCE

The company's reinsurance portfolio and strategy is described below. A list of the companies that have a significant amount of reinsurance in force at the time of the examination follows. The contracts contained proper insolvency provisions.

Nonaffiliated Ceding Contracts

1.	Type:	Property and Casualty Excess of Loss
	Cedants:	Capitol Indemnity Corporation and its affiliates
	Reinsurer:	GE Reinsurance Corporation (33%), Hartford Fire Ins. Co. (33%), and Partner Reinsurance Company of the U.S. (34%)
	Scope:	All business classfied by the Company as Property and Casualty with stated exclusions
	Retention	
	Property Business:	$1,000,000 in respect to each risk
	Casualty Business:	$1,000,000 in respect to one loss occurrence and/or claim made
	Combined Prop/Cas:	$1,000,000 in respect to any one occurrence and/or claim made, which will be prorated between the two classes of business
	Coverage	
	Property Business:	$4,000,000 excess of $1,000,000 in respects to a loss for each risk or $8,000,000 excess of $1,000,000 in respect of any one loss occurrence
	Casualty Business:	$2,000,000 excess of $1,000,000 in respects to any one loss occurrence and/or claim made. The reinsurer's annual aggregate limit of liability for the term of this agreement will not exceed $6,000,000
	Combined Prop/Cas:	The amount of the reinsurer's liability will be increased by an amount up to 100% of the company's retention in respect to the occurrence and/or claim, which will be prorated between the two classes of business
	Premium:	3.7% of the gross net written premium written or renewed
	Effective date:	Continuous and to take effect December 1, 2001, 12:01 a.m. standard time as respects the new and renewal business
	Termination:	Any December 1, by either party giving at least 90 days' prior written notice. Run-off to policy expiration or renewal date, whichever comes first. Cut-off only if mutually agreed upon, in which event Reinsurers will immediately return their pro rata portion of unearned premium
2.	Type:	Umbrella Quota Share/Excess of Loss

Cedants:	Capitol Indemnity Corporation and its affiliates
Reinsurer:	GE Reinsurance Corporation (33%), Hartford Fire Ins. Co. (33%), and Partner Reinsurance Company of the U.S. (34%)
Scope:	All business classfied by the Company as commercial umbrella policies with stated exclusions
Retention	
First Layer:	15% of each loss occurrence not to exceed $150,000
Second Layer:	5% of each loss occurrence in excess of $1,000,000 not to exceed $200,000
Coverage	
First Layer:	85% of $1,000,000 per loss occurrence
Second Layer:	95% of $4,000,000 excess of $1,000,000
Premium	
First Layer:	85% of the gross net written premium charged by the company for the first $1,000,000 in coverage
Second Layer:	95% of the gross net written premium charged by the company for limits above $1,000,000 up to and including $5,000,000 in coverage
Ceding Commission:	28.5% of gross net written premium
Effective date:	Continuous and to take effect December 1, 2001, 12:01 a.m. standard time as respects the new and renewal business
Termination:	Any December 1, by either party giving at least 90 days' prior written notice. Run-off to policy expiration or renewal date, whichever comes first. Cut-off only if mutually agreed upon, in which event Reinsurers will immediately return their pro rata portion of unearned premium

3. Type: Workers' Compensation Carve Out Excess of Loss

Cedants:	Capitol Indemnity Corporation and its affiliates
Reinsurer:	GE Reinsurance Corporation
Scope:	All business classfied by the Company as workers' compensation and employers liability
Retention:	$1,000,000 in respect to each loss occurrence
Coverage:	$4,000,000 in excess of $1,000,000 in respect to any one loss occurrence not to exceed $8,000,000 for the term of this agreement

	Premium:	A deposit premium of $300,000, payable in equal quarterly installments, adjusted to 3.75% of the company's net earned premium, after the expiration of the agreement
	Effective date:	December 1, 2001
	Termination:	December 1, 2002
4.	Type:	Fidelity and Surety Excess of Loss
	Cedants:	Capitol Indemnity Corporation and its affiliates
	Reinsurer:	Continental Casualty Company (25%), Hannover Ruckversicherungs - Aktiengesellschaft (25%), and Berkley Insurance Company (50%)
	Scope:	All bond business underwriten by the Company's Fidelity and Surety Department and classified by the company as Surety and Fidelity
	Retention	
	First Layer	
	Surety:	$1,000,000 ultimate net loss each principal
	Fidelity:	$1,000,000 ultimate net loss each loss event
	Annual Aggregate:	$1,000,000 of ultimate net loss otherwise recoverable hereunder
	Second Layer	
	Surety:	10% of $2,000,000 ultimate net loss each principal excess of $3,000,000 ultimate net loss each principal
	Fidelity:	10% of $2,000,000 ultimate net loss each loss event, excess of $3,000,000 ultimate net loss
	Coverage	
	First Layer	
	Surety:	$2,000,000 ultimate net loss each principal in excess of $1,000,000
	Fidelity:	$2,000,000 ultimate net loss each loss event in excess of $1,000,000
	Maximum Limit:	$6,000,000 in the aggregate any one agreement year
	Second Layer	
	Surety:	90% of $2,000,000 ultimate net loss each principal excess of $3,000,000 ultimate net loss each principal
	Fidelity:	90% of $2,000,000 ultimate net loss each insured, each loss event, excess of $3,000,000 ultimate net loss

	Maximum Limit:	90% of $4,000,000 in the aggregate any one agreement year
	Premium:	
	First Layer:	Minimum and deposit premium of $1,420,000, payable in equal quarterly installments, adjusted to 6.45% of subject gross net written premium
	Second Layer:	Minimum and deposit premium of $507,000, payable in equal quarterly installments, adjusted to 2.30% of subject gross net written premium
	Effective date:	December 1, 2001
	Termination:	Any December 1, by either party giving at least 90 days prior written notice
5.	Type:	Equipment Breakdown Liability Quota Share
	Reinsurer:	The Hartford Steam Boiler Inspection and Insurance Company
	Scope:	Equipment breakdown liability business of the company with stated exclusions
	Retention:	0%
	Coverage	100% of the equipment breakdown liability on any one risk up to $25,000,000
	Premium:	100% of the net written premium determined by the company for equipment breakdown liability business
	Effective date:	April 1, 1996
	Termination:	By either party giving the other six months' prior written notice in writing
6.	Type:	100% Quota Share
	Reinsurer:	First Commonwealth Reinsurance Company
	Scope:	Group dental policies providing either network or non-network plan indemnity coverage written in the State of Michigan
	Retention:	0%
	Coverage:	100%
	Premium:	Total premium collected for the specific line of coverage
	Commission:	5%
	Effective date:	June 30, 1998

Termination:	By either party at any time, by giving the other party not less than 180 days' prior notice by certified mail. This agreement will be terminated in 2003

Affiliated Assuming Contracts

1.	Type:	100% Quota Share
	Reinsured:	Capitol Specialty Insurance Corporation
	Scope:	All business written
	Retention:	0%
	Coverage:	100%
	Premium:	All premium collected by the ceding company
	Commissions:	25%
	Effective date:	August 1, 1997
	Termination:	12:01 A.M. on any January 1

VI. FINANCIAL DATA

The following financial statements reflect the financial condition of the company as reported in the December 31, 2001, annual statement to the Commissioner of Insurance. Also included in this section are schedules that reflect the growth of the company, NAIC Insurance Regulatory Information System (IRIS) ratio results for the period under examination, and the compulsory and security surplus calculation. Adjustments made as a result of the examination are noted at the end of this section in the area captioned "Reconciliation of Surplus per Examination."

Capitol Indemnity Corporation
Assets
As of December 31, 2001

	Assets	Nonadmitted Assets	Net Admitted Assets
Bonds	$ 94,090,809	$ 0	$ 94,090,809
Stocks:			
Preferred stocks	3,749,267		3,749,267
Common stocks	106,291,043		106,291,043
Real estate:			
Properties held for sale	11,525,201		11,525,201
Cash	8,195,696		8,195,696
Receivable for securities	1,098,486		1,098,486
Agents' balances or uncollected premiums:			
Premiums and agents' balances in course of collection	21,035,477	633,956	20,401,521
Premiums, agents' balances, and installments booked but deferred and not yet due	2,275,009		2,275,009
Funds held by or deposited with reinsured companies	62,000		62,000
Reinsurance recoverable on loss and adjustment payments	722,739		722,739
Federal and foreign income tax recoverable and interest thereon	11,851,494		11,851,494
Guaranty funds receivable or on deposit	114,241		114,241
Electronic data processing equipment and software			
Interest, dividends, and real estate income due and accrued	1,924,924		1,924,924
Write-ins for other than invested assets			
Prepaid Insurance	54,505	54,505	
Other Assets	1,041,592		1,041,592
Taxes, licenses & Fees Receivable	304,133		304,133
Total Assets	$264,336,616	$688,461	$263,648,155

Capitol Indemnity Corporation
Liabilities, Surplus, and Other Funds
As of December 31, 2001

Losses	$ 63,140,781
Reinsurance payable on paid loss and loss adjustment expenses	10,965
Loss adjustment expenses	26,021,732
Commissions payable, contingent commissions, and other similar charges	3,119,343
Other expenses (excluding taxes, licenses, and fees)	1,102,343
Unearned premiums	55,465,203
Dividends declared and unpaid:	
Policyholders	180,481
Ceded reinsurance premiums payable (net of ceding commissions)	3,840,232
Amounts withheld or retained by company for account of others	373,695
Provision for reinsurance	52,400
Drafts outstanding	4,839,372
Payable to parent, subsidiaries, and affiliates	74,050
Payable for securities	500,788
Write-ins for liabilities:	
Funds held under reinsurance assumed treaties	421,302
Reserve for return of disability premiums	3,145
Total Liabilities	159,145,832
Common capital stock	2,002,352
Gross paid in and contributed surplus	781,686
Unassigned funds (surplus)	101,718,285
Surplus as Regards Policyholders	104,502,323
Total Liabilities and Surplus	$263,648,155

Capitol Indemnity Corporation
Summary of Operations
For the Year 2001

Underwriting Income	
Premiums earned	$100,753,014
Deductions:	
Losses incurred	65,108,420
Loss expenses incurred	12,757,877
Other underwriting expenses incurred	36,685,642
Total underwriting deductions	114,551,939
Net underwriting gain or (loss)	(13,798,925)
Investment Income	
Net investment income earned	9,652,286
Net realized capital gains or (losses)	(14,005,383)
Net investment gain or (loss)	(4,353,097)
Other Income	
Finance and service charges not included in premiums	417,810
Write-ins for miscellaneous income:	
Miscellaneous income	279,892
Total other income	697,702
Net income (loss) before dividends to policyholders and before federal and foreign income taxes	(17,454,320)
Dividends to policyholders	726,128
Net income (loss) after dividends to policyholders but before federal and foreign income taxes	(18,180,448)
Federal and foreign income taxes incurred	(7,619,549)
Net Loss	$(10,560,899)

Capitol Indemnity Corporation
Cash Flow
As of December 31, 2001

Premiums collected net of reinsurance	$109,761,232		
Loss and loss adjustment expenses paid (net of salvage or subrogation)	68,003,454		
Underwriting expenses paid	37,339,525		
Other underwriting income (expenses)	(15,224)		
Cash from underwriting		$4,403,029	
Investment income (net of investment expense)		9,145,913	
Other income (expenses):			
Net funds held under reinsurance treaties	3,513		
Net amount withheld or retained for account of others	55,723		
Miscellaneous	697,706		
Total other income		756,942	
Deduct:			
Dividends to policyholders paid		638,610	
Federal income taxes paid (recovered)		1,013,943	
Net cash from operations			$12,653,331
Proceeds from investments sold, matured, or repaid:			
Bonds	16,364,308		
Stocks	58,081,002		
Miscellaneous proceeds	3,466,827		
Total investment proceeds		77,912,137	
Cost of investments acquired (long-term only):			
Bonds	31,619,871		
Stocks	41,765,841		
Total investments acquired		73,385,712	
Net cash from investments			4,526,425
Cash provided from financing and miscellaneous sources:			
Net transfers from affiliates	74,050		
Other cash provided	133,239		
Total		207,289	
Cash applied for financing and miscellaneous uses:			
Dividends to stockholders paid	15,008,763		
Total		15,008,763	
Net cash from financing and miscellaneous sources			(14,801,474)
Net change in cash and short-term investments			2,378,282
Reconciliation			
Cash and short-term investments, December 31, 2000			5,817,414
Cash and short-term investments, December 31, 2001			$ 8,195,696

Capitol Indemnity Corporation
Compulsory and Security Surplus Calculation
December 31, 2001

Assets		$263,648,155	
Less liabilities		159,145,832	
Adjusted surplus			$104,502,323
Annual premium:			
Individual accident and health	$290,413		
Factor	25%		
Total		72,603	
Lines other than accident and health	111,328,107		
Factor	25%		
Total		27,832,027	
Compulsory surplus (subject to a minimum of $2 million)			27,904,630
Compulsory surplus excess (or deficit)			$ 76,597,693
Adjusted surplus (from above)			$104,502,323
Security surplus: (125% of compulsory surplus)			34,880,789
Security surplus excess (or deficit)			$ 69,621,536

The company is under a Wisconsin compulsory and security surplus order effective since October 15, 1980. This order states that the company comply with the following:

(1) As of each period ending December 31, the company shall maintain compulsory security surplus of an amount equal to 25% of net premium written for all lines of business
(2) Surplus shall mean “Surplus as Regards Policyholders” as computed on the statutory accounting basis
(3) Net premiums shall be all net premiums (Including reinsurance assumed) booked by the company
(4) The insurer shall make all reasonable efforts to record and book promptly all premium in force
(5) Security surplus is 125% of compulsory surplus for each period ending December 31
(6) The company shall submit with each quarterly and annual statement, a computation of compulsory security surplus
(7) The company shall submit to the Commissioner 30 days prior to it implementating any material change in its current business plan.

See the section of this report titled “Summary of Current Examination Results” as a recommendation to remove this requirement was made as a result of this examination.

Capitol Indemnity Corporation
Reconciliation and Analysis of Surplus
For the Five-Year Period Ending December 31, 2001

The following schedule is a reconciliation of total surplus during the period under examination as reported by the company in its filed annual statements:

	1997	1998	1999	2000	2001
Surplus, beginning of year	$86,880,871	$109,324,112	$102,902,836	$91,570,236	$107,917,383
Net income	13,162,055	19,051,239	16,306,022	13,003,336	(10,560,899)
Net unrealized capital gains or (losses)	16,837,492	(22,766,655)	(29,037,586)	4,026,411	15,696,250
Change in net deferred income tax					6,193,191
Change in non-admitted assets	(992,115)	525,140	(9,036)	(578,200)	373,635
Change in provision for reinsurance	12,809			(400)	(52,000)
Cumulative effect of changes in accounting principles					(56,474)
Dividends to stockholders	(4,000,000)	(4,500,000)		(5,000,000)	(15,008,763)
Write-ins for gains and (losses) in surplus:					
Change in excess of statutory reserves over statement reserves	(2,577,000)	1,269,000	1,408,000	4,896,000	
Surplus, end of year	$109,324,112	$102,902,836	$91,570,236	$107,917,383	$104,502,323

Capitol Indemnity Corporation
Insurance Regulatory Information System
For the Five-Year Period Ending December 31, 2001

The following is a summary of NAIC Insurance Regulatory Information System (IRIS) results for the period under examination. Exceptional ratios are denoted with asterisks. A discussion of the exceptional ratios may be found after the IRIS ratios.

	Ratio	1997	1998	1999	2000	2001
#1	Gross Premium to Surplus	91.0%	85.0%	94.0%	95.0%	122.0%
#2	Net Premium to Surplus	84.0	80.0	88.0	87.0	108.0
#3	Change in Net Writings	2.0	(10.0)	(3.0)	17.0	20.0
#4	Surplus Aid to Surplus	0.0	0.0	0.0	0.0	0.0
#5	Two-Year Overall Operating Ratio	87.0	91.0	85.0	87.0	95.0
#6	Investment Yield	3.9*	3.5*	4.2*	4.3*	4.4*
#7	Change in Surplus	23.0	(6.0)	(10.0)*	17.0	(1.0)
#8	Liabilities to Liquid Assets	61.0	61.0	64.0	64.0	72.0
#9	Agents' Balances to Surplus	12.0	12.0	13.0	14.0	20.0
#10	One-Year Reserve Devel. to Surplus	20.0*	5.0	(3.0)	(3.0)	9.0
#11	Two-Year Reserve Devel. to Surplus	30.0*	25.0*	0.0	(6.0)	(1.0)
#12	Estimated Current Reserve Def. To Surplus	4.0	2.0	(10.0)	(5.0)	8.0

Ratio No. 5 measures the average return on the company's investments. The exceptional investment yield is partially attributable to the company's large equity investments, which resulted in a comparatively lower rate of return. Current management has increased tax-free bond holdings and de-emphasized the equity portfolio due to the recent volatility in the equity markets.

Ratio No. 10 and No. 11, measures the development of the company's reserves compared to surplus. The exceptional results noted in 1997 and 1998 is due to adverse development of the company's reserves as compared to its previous estimates. See the section of this report captioned "Summary of Current Examinations Results" for additional comments on loss reserve adequacy and other reserving issues.

Growth of Capitol Indemnity Corporation

Year	Admitted Assets	Liabilities	Surplus As Regards Policyholders	Net Income
1997	$249,465,870	$140,141,759	$109,324,111	$13,162,055
1998	237,355,448	134,452,612	102,902,836	19,051,239
1999	221,165,486	129,595,250	91,570,236	16,306,022
2000	245,238,153	137,320,769	107,917,384	13,003,336
2001	263,648,155	159,145,832	104,502,323	(10,560,899)

Year	Gross Premium Written	Net Premium Written	Premium Earned	Loss And LAE Ratio	Expense Ratio	Combined Ratio
1997	$99,360,906	$91,417,855	$87,304,679	70.3%	32.6%	102.9%
1998	87,802,645	82,649,466	88,502,969	59.4	36.2	95.6
1999	86,002,800	80,193,376	82,841,104	54.9	37.0	91.9
2000	102,110,216	93,891,782	88,184,842	65.4	34.9	100.3
2001	127,949,211	112,344,648	100,753,014	77.3	32.0	109.3

Capitol Indemnity reported net income for every year under examination with the exception of 2001. Management indicated that the net loss reported in 2001 was primarily due to a decrease in underwriting income as a result of increased severity of fire losses in the restaurant and tavern market as well as adverse development on one major 2000 surety contract claimin the first few months of 2001. Additionally, Capitol Indemnity's reserves were strengthened at year-end 2001 to increase conservatism in its reserving philosophy consistent with Alleghany's historical methods for its insurance subsidiaries, as Alleghany controlled the company when the 2001 annual statement was prepared.

After consecutive years of reductions in premium volume on both a gross and net basis in 1998 and 1999, the company's premium volume during the examination period still ended significantly higher than in 1997. An increase of approximately 29% and 23% was noted on a gross and net basis, respectively.

Reconciliation of Surplus per Examination

The following schedule is a reconciliation of surplus as regards policyholders between that reported by the company and as determined by this examination:

Surplus December 31, 2001, per Annual Statement			$104,502,323
	Increase	**Decrease**	
Unpaid Losses	$	$19,955,000	
Real Estate		663,519	
Premiums, agents' balances and installments booked but deferred and not yet due		445,220	
Federal and foreign income tax recoverable and interest thereon	163,506		
Aggregate write-ins for other than invested assets		828,663	
Net increase or (decrease)	$163,506	$21,892,402	(21,728,896)
Surplus December 31, 2001, per Examination			$ 82,773,427

Examination Reclassifications

	Debit	**Credit**
Premiums, agents' balances and installments booked but deferred and not yet due	$17,462,478	$
Premiums and agents' balances in course of collection		17,462,478
Total reclassifications	$17,462,478	$17,462,478

VII. SUMMARY OF EXAMINATION RESULTS

Compliance with Prior Examination Report Recommendations

There were eight specific recommendations in the previous examination report. Recommendations contained in the last examination report and actions taken by the company are as follows:

1. Articles and Bylaws — It is recommended that the company file bylaw amendments with the Commissioner's office in a timely manner in accordance with s. 611.12 (4), Wis. Stat.

   Action — Compliance.

2. Reporting of Transactions with Affiliates — It is recommended that the company comply with ch 617, Wis. Stat., ch. Ins. 40 and s. Ins 6.52, Wis. Adm. Code, and NAIC annual statement instructions, regarding the reporting of and prior regulatory review of transactions with affiliates, including but not limited to:

   - Accurate reporting of terms of affiliated agreements;
   - Accurate reporting of intercompany transactions that occurred during the period, on the holding company annual registration statement;
   - Complete and accurate disclosure of intercompany transactions on the annual statement as required by NAIC Annual Statement Instructions-Property and Casualty;
   - Reporting material transactions to the commisssioner for prior review;
   - Executing written loan or promissory note agreements signed by both parties for any monies loaned to affiliates;
   - Board approval of intercompany loans prior to execution; and
   - Filing current biographical information on directors.

   Action — Partial compliance, see comments in the summary of current examination results.

3. Fidelity Bond Coverage — It is recommended that the company increase its fidelity insurance coverage in respects to the level of its exposure index in accordance to the NAIC Examiners Handbook.

   Action — Compliance.

4. Information Technology — It is recommended that the company:

- Create a disaster recovery plan that is specific to its operations, addressing all company functions, and review and test the plan on a periodic basis, at least annually; and
- Require personnel to change their passwords at least quarterly.

Action — Compliance.

5. Other Assets/Expenses — It is recommended that the company comply with NAIC Annual Statement Instructions-Property and Casualty and Practices and Procedures Manual for Property/Casualty Insurance Companies, including but not limited to:

   - Nonadmitting all travel advances and prepaid insurance;
   - Reporting all affiliated common stock holdings, purchases, and sales in Schedule D;
   - Reporting gains and losses on affiliated common stock in the "Underwriting and Investment Exhibit Part 1A";
   - Ensuring that all receivables and payables are correctly classified; and
   - Properly reporting policyholder dividends declared by the board and unpaid at year-end.

   Action—Partial compliance, see comments in the summary of current examination results.

6. Loss and LAE Reserves — It is again recommended that the company develop an adequate actuarial database for the assumed reinsurance business.

   Action — Compliance.

7. Loss and LAE Reserves — It is recommended that the company's opining actuary review the assumed reinsurance business and include it in all future Statements of Actuarial Opinion.

   Action — Compliance.

8. Loss and LAE Reserves — It is recommended that the company's opining actuary:

   - Follow closely the suggested actuarial opinion wording contained in the NAIC Annual Statement Instructions-Property and Casualty;
   - Provide a complete reconciliation of the data used to formulate the Statement of Actuarial Opinion to the Annual Statement, Schedule P which includes all accident year experience;
   - Utilize tail factors for potential development beyond those directly calculated in the reserve methodologies and employ actuarial judgement and reasonability checks, such as implied average severities, in the selection of ultimate losses; and
   - Provide a description of the amount of retainage included as negative case reserves in the fidelity and surety line.

   Action — Compliance.

Summary of Current Examination Results

Holding Company Annual Registration Statement

The company must annually file with the Commissioner a "Holding Company Annual Registration Statement" pursuant to ch. Ins 40, Wis. Adm. Code. This statement is to be filed by June 1 of each subsequent year for the immediately preceding calendar , and "it shall contain …. Information which is current on the date of filing" [s. Ins 40.03 (3), Wis. Adm. Code].

The previous examination noted several instances in which the company did not properly disclose various agreements with affiliates in its Holding Company Annual Registration Statement for 1996. The examiner's review of the statement for year 2001, indicated that an affiliated administrative service agreement between Capitol Indemnity and Capitol Facilities was not properly identified in its Holding Company Annual Registration Statement. It is again recommended that the company properly file its Holding Company Annual Registration Statement, pursuant to s. Ins. 40.03, Wis. Adm. Code.

Corporate Records

In 1997, Capitol Indemnity entered into an arrangement to assume a block of group dental policies, providing either network or non-network plan indemnity coverage, written in the State of Michigan by an unaffiliated Wisconsin domestic. All of the business was retroceded under a quota share reinsurance agreement with First Commonwealth Reinsurance Company, a company neither licensed nor accredited in the State of Wisconsin. This arrangement has changed several times since 1997. However, Capitol Indemnity continued to cede 100% of this business to First Commonwealth Reinsurance Company regardless of the changes. See the section of this report titled "Reinsurance" for additional information regarding this contract.

The latest change occurred in June of 1998, as First Commonwealth, Inc., a Delaware corporation and an affiliate of First Commonwealth Reinsurance Company, entered into an agency agreement with Capitol Indemnity to act as a third party administrator on behalf of the company. First Commonwealth, Inc., administers all aspects of this block of business including planning, product design, product procurement, underwriting, claims handling, and miscellaneous activities, necessary for the day-to-day operations of the program, on behalf of Capitol Indemnity. This business should have been reported as direct written premium by Capitol

Indemnity. However, Capitol Indemnity improperly reported this business as assumed from First Commonwealth Reinsurance Company.

This error resulted in numerous inaccuracies in its filed Statutory Annual Statements since 1998, as well as underpayments of premium tax due the state of Michigan and various other assessments that would be based off the direct premium written reported by the company. Based on this discovery, management was able to properly report this business in its 2002 Statutory Annual Statement. In addition, the company contacted the Michigan Department of Revenue and is in negotiations to settle the amounts owed.

The aforementioned issue highlighted difficulties experienced by personnel in both physical retrieval of corporate records and understanding of certain arrangements that previous management had entered into and warrants the creation of an index of corporate records. Such an index would enhance senior management's ability to assess the company's commitments and contingent exposures on an ongoing basis, and to determine whether these are adequately formalized and disclosed both at the date of inception and during subsequent amendments. Therefore, it is recommended that the company complete its development of a procedure whereby an index of corporate contracts is maintained, pursuant to s. 601.42, Wis. Statutes. The index should include all affiliated agreements without exception, together with nonaffiliated agreements that meet written scope or materiality criteria established by either management guidelines or board resolution.

Investment Reconciliations

The examination noted that during 2001, the company had only performed a formal investment reconciliation between company records and custodial records at year-end. Effective June 30, 2002, the company implemented controls to perform formal reconciliations on a monthly basis. Timely reconciliations are an essential element of an adequate control environment to ensure investments are properly maintained and accounted for. It is recommended that the company continue to perform formal reconciliations of investments to custodian records on a monthly basis.

Safekeeping Agreements

Section Ins 610.23, Wis. Stat., requires insurers to hold all investments and deposits of its funds in its own name except that:

(1) Securities kept under a custodial agreement or trust arrangement with a bank or banking and trust company may be issued in the name of a nominee of the bank or banking and trust company; and

(2) Any insurer may acquire and hold securities in bearer form.

The company is not in compliance with these requirements. The company had several securities that were neither held under a trust agreement with a bank or banking and trust company nor maintained in the company's safe as required by s. Ins 610.23, Wis. Stat. The securities in question were book entry securities purchased through and held by a brokerage firm. It is recommended that the company comply with s. Ins 610.23, Wis. Stat., with regard to custody and control of its invested assets. The securities were transferred to the company's custodian in 2002.

A bank holds the remainder of the company's securities under a safekeeping agreement. However, the agreement did not contain satisfactory safeguards and controls as specified in the National Association of Insurance Commissioners (NAIC) Examiners Handbook. It is recommended that the company amend its safekeeping agreement to include provisions requiring:

> That the custodian is obligated to indemnify the company for any loss of securities of the company in the trust company's custody occasioned by the negligence or dishonesty of the trust company's officers or employees, or burglary, robbery, holdup, theft, or mysterious disappearance, including loss by damage or destruction; and
>
> That in the event that there is a loss of the securities for which the custodian is obligated to indemnify the company, the securities shall be promptly replaced or the value of the securities and the value of any loss of rights or privileges resulting from said loss of securities shall be promptly replaced.

Real Estate **$10,861,682**

This asset reported above includes a decrease of $663,519 made by the examination. This asset is comprised of two properties held for sale by the company. The examination adjustment is the result of the company improperly reporting carrying value of one of the properties at its depreciable cost instead of its fair value, which in this case was lower. In accordance with SSAP 40, paragraph 10, properties held for sale shall be carried at the lower of depreciated cost or fair value less encumbrances and estimated costs to sell the property. It is recommended that in future annual statements the company properly carry real estate investments in accordance with the NAIC Accounting Practices and Procedures Manual.

The examination also noted that the company was improperly capitalizing certain expenditures that should have been expensed. In accordance with SSAP 40, paragraph 14, expenditures that are necessary to put the asset back into good operating condition or to keep it in good operating condition, shall be expensed as incurred. The company expensed items under a self-imposed threshold, but did not review invoices for specific items that were repair or maintenance in nature. No adjustment to surplus is proposed due to lack of materiality. However, it recommended that the company implement procedures necessary to properly account for real estate expenditures in accordance with the NAIC Accounting Practices and Procedures Manual.

Premium Receivables (A/S Lines 10.1 and 10.2) $22,676,530

The company reported $21, 035,477 as "Premiums and agents' balances in course of collection" (A/S line 10.1) and $2,275,009 as "Premiums, agents' balances and installments booked but deferred and not yet due" (A/S line 10.2) in its 2001 statutory annual statement. The examination noted that due to an oversight, company personnel had inadvertently missallocated system reports between the two accounts. The examination made a reclassification of $17,462,478 from "Premiums and agents' balances in course of collection" to "Premiums, agents' balances and installments booked but deferred and not yet due", to correct the misallocation.

Collateral Loans

In accordance with Statement of Statutory Accounting Principles (SSAP) 21, paragraph 4, "… collateral loans secured by assets that do not qualify as investments shall be nonadmitted. Further, any amount of the loan outstanding which is in excess of the permitted relationship of fair value of the pledged investment to the collateral loan shall be treated as a nonadmitted asset." The company reported $1,273,883 of note receivables for which either the company had no security interest, or were secured by an asset that did not qualify as an admitted asset. Examples included: notes receivable from agencies that the company did business with, structured settlement receipts, and other miscellaneous notes. The examination nonadmitted the entire $1,273,883 of improperly collateralized loans. This included $445,220 of agency notes reported within “premiums and agents’ balances in course of collection” and $828,663 reported as “other than invested assets”. It is also recommended that the company properly nonadmitt loans or other notes receivable that are not properly collateralized in accordance with SSAP 21.

Audit Premiums

Capitol Indemnity’s 2001 statutory annual statement did not include an estimate for accrued audit premium receivable. According to Statements of Statutory Accounting Principles (SSAP), No. 53, paragraph 9, “Adjustments to the premium charged for changes in the level of exposure to insurance risk (e.g., audit premiums on workers’ compensation policies) are generally determined based upon audits conducted after the policy has expired. Reporting entities shall estimate audit premiums, the amount generally referred to as earned but unbilled (EBUB) premium, and shall record the amounts as an adjustment to premium, either through written premium or as an adjustment to earned premium.”

No adjustment to surplus is proposed due to lack of materiality. However, it is recommended that in future annual statements, the company properly estimate and report audit premium in accordance with the NAIC Accounting Practices and Procedures Manual.

Federal and Foreign Income Tax Recoverable and Interest Thereon $13,483,500

The examination noted that errors occurred in the build up of certain tax-related amounts presented or disclosed in the company’s statutory annual statement as of December 31, 2001. These errors resulted in the company overstating its federal income tax recoverable and understating its admitted deferred tax asset. These errors also affected the “cumulative effect of changes in accounting principles” resulting from the initial adoption of codification that was reported by the company. The company has corrected these errors in its 2002 annual statement. The examination made an adjustment to increase surplus by $163,506 that was the net impact to surplus of these offsetting errors.

Unpaid Losses $109,118,000

This liability represents the company’s estimate of amounts payable on losses incurred on or prior to December 31, 2001, and remaining unpaid as of that date. As noted earlier, independent actuaries were engaged under a contract with the Office of the Commissioner of Insurance. They reviewed the adequacy of the company's loss reserves and loss adjustment expense reserves. The independent actuaries determined that the company's reserves were understated by $19,955,000.

The following table is a comparison of amounts reported by the company and those selected by our independent actuaries:

	All amounts in thousands		
	Company	Exam	
	Recorded	Selected	Surplus
Actuarial Line of Business	Net Reserves	Net Reserves	Change
Commercial Multiple Peril	$ 50,108	$ 62,647	$(12,539)
Other Liability	13,377	17,403	(4,026)
Workers' Compensation	5,298	4,038	1,260
Fidelity & Surety	5,437	10,087	(4,650)
Non-Reviewed Lines	10,992	10,992	-
Total Loss & DCC	85,212	105,167	(19,955)
Adjusting & Other	3,951	3,951	-
Grand Total Loss & LAE	$ 89,163	$ 109,118	(19,955)

As noted earlier, effective January 4, 2002, Alleghany Corporation announced the closing of a merger agreement under which Alleghany purchased Capitol Transamerica Corporation, the ultimate parent of Capitol Indemnity. During 2002, Capitol Indemnity strengthened its net loss reserves by approximately $17.3 million. This development included a significant shift of dollars from IBNR reserve to case reserves, as previously IBNR had included a margin for inadequate case reserves. Management believes the company has addressed the issues raised by this examination by strengthening company reserves in 2002.

It is important to note that the examination adjustment reflects OCI's consulting actuary's best estimate using information available as of September 30, 2002, and the company's development reflects management's best estimate as of December 31, 2002. The difference of approximately $2.8 million may be partially attributed to this timing difference. In addition, the company's December 31, 2002, reserves for losses incurred in 2001 and prior would fall within the range of reasonable estimates determined by OCI's consulting actuary.

Remittances and Items Not Allocated

The examination noted that the company did not report any balance for the above referenced account. However, during the examiners' review of the company's premium receivable accounts, it was noted that unapplied cash had been netted within the account. In accordance with SSAP 67, paragraph 9, and in accordance with the NAIC Annual Statement Instructions—Property and Casualty, unidentified cash receipts should be reported as "Remittances and Items Not Allocated".

A reclassification for purposes of this examination is not deemed necessary, since the net of these balances was not considered material. However, it is recommended that in future annual statements, the company properly report unidentified cash receipts in accordance with the NAIC Accounting Practices and Procedures Manual and the the NAIC Annual Statement Instructions—Property and Casualty.

Compulsory and Security Surplus

The company has been under a Wisconsin compulsory and security surplus order effective since October 15, 1980. At that time, the order was imposed after considering several factors including the frequency and severity of the company's losses incurred between 1975 and 1980, in relation to its surplus. This order has remained in place and appears no longer necessary given the current reserving practices as well as capital position of the company in comparison to its operational results. As a consequence of this examination, the Compulsory and Security Surplus Order dated October 15, 1980, will be lifted as of the adoption of this report. The company would then use the factors prescribed in s. Ins 51.80, Wis. Adm. Code, to compute compulsory surplus and security surplus.

VIII. CONCLUSION

As noted earlier, several significant events have occurred subsequent to the “as of date” of this report. These subsequent events have included the sale of its direct parent, Captitol Transamerica Corporation, to Alleghany, the acquisition of another insurance affiliate by Alleghany, the establishment of an affiiated pooling arrangement, and significant capital contributions by Alleghany of securities and a subsidiary to the Company. For additional information related to these events see the section of this report titled “Appendix — Subsequent Events”.

Capitol Indemnity’s policyholders’ surplus decreased by 24%, from $109,324,111 on December 31, 1997, to $82,773,427 million (as determined by this examination report) in 2001. During the same period, gross premium written increased by 29%, while net premium written has increased by 23%. In addition, Capitol Indemnity reported net income in four out of the last five years.

The examination resulted in ten recommendations, two of which were repeated from the previous examination. The examination also reduced surplus by $21,728,896, the majority of which related to the company’s reported reserves, and reclassified an additional $17,462,478 on the balance sheet. Current management’s efforts and success in addressing the majority of issues raised in this report prior to its issuance is hereby acknowledged.

IX. SUMMARY OF COMMENTS AND RECOMMENDATIONS

1. Page 32 - Holding Company Registration Statement — It is again recommended that the company properly file its Holding Company Annual Registration Statement, pursuant to s. Ins. 40.03, Wis. Adm. Code.

2. Page 32 - Corporate Records — It is recommended that the company complete its development of a procedure whereby an index of corporate contracts is maintained, pursuant to s. 601.42, Wis. Stats. The index should include all affiliated agreements without exception, together with nonaffiliated agreements that meet written scope or materiality criteria established by either management guidelines or board resolution.

3. Page 33 - Investment Reconciliations — It is recommended that the company continue to perform formal reconciliations of investments to custodian records on a monthly basis.

4. Page 34 - Safekeeping Agreements — It is recommended that the company comply with s. 610.23, Wis. Stat., with regard to custody and control of its invested assets.

5. Page 34 - Safekeeping Agreements — It is recommended that the company amend its safekeeping agreement to include provisions requiring:

   That the custodian is obligated to indemnify the company for any loss of securities of the company in the trust company's custody occasioned by the negligence or dishonesty of the trust company's officers or employees, or burglary, robbery, holdup, theft, or mysterious disappearance, including loss by damage or destruction; and

   That in the event that there is a loss of the securities for which the custodian is obligated to indemnify the company, the securities shall be promptly replaced or the value of the securities and the value of any loss of rights or privileges resulting from said loss of securities shall be promptly replaced.

6. Page 34 - Real Estate — It is recommended that in future annual statements the company properly carry real estate investments in accordance with the NAIC Accounting Practices and Procedures Manual.

7. Page 35 - Real Estate — it recommended that the company implement procedures necessary to properly account for real estate expenditures in accordance with the NAIC Accounting Practices and Procedures Manual.

8. Page 35 - Collateral Loans — It is also recommended that the company properly nonadmitt loans or other notes receivable that are not properly collateralized in accordance with SSAP 21.

9. Page 36 - Audit Premiums — It is recommended that in future annual statements, the company properly estimate and report audit premium in accordance with the NAIC Accounting Practices and Procedures Manual.

10. Page 38 - Remittances and Items Not Allocated — It is recommended that in future annual statements, the company properly report unidentified cash receipts in accordance with the NAIC Accounting Practices and Procedures Manual and the the NAIC Annual Statement Instructions—Property and Casualty.

X. ACKNOWLEDGMENT

The courtesy and cooperation extended during the course of the examination by the officers and employees of the company are acknowledged.

In addition to the undersigned, the following representatives of the Office of the Commissioner of Insurance, State of Wisconsin, participated in the examination:

Name	Title
Cruz Flores	Data Processing Audit Specialist
John Litweiler	Insurance Financial Examiner
Rick Anderson	Insurance Financial Examiner
Sheur Yang	Insurance Financial Examiner

Respectfully submitted,

Tim Vande Hey
Examiner-in-Charge
Senior Insurance Financial Examiner

XI. APPENDIX—SUBSEQUENT EVENTS

As stated earlier, effective January 4, 2002, Alleghany announced the closing of a merger agreement under which Alleghany purchased Capitol Transamerica (Capitol Indemnity's ultimate parent at the time) for approximately $182 million in cash. Prior to the purchase Capitol Transamerica was a publicly traded company whose common stock was traded through the National Association of Securities Dealers.

Effective January 3, 2002, in a separate transaction, Alleghany purchased 100% of the common stock of Platte River Insurance Company (Platte River), formerly known as Underwriters Insurance Company. In this way, Platte River became an affiliate of Capitol Indemnity and Capitol Specialty.

Effective January 30, 2002, Capitol Indemnity Corporation acquired all renewal rights and certain other assets of The Connecticut Surety Company ("CSC"), a Connecticut domiciled insurance company, and its affiliates, and CIC hired some former management and staff of CSC. CSC wrote a $14 million dollar book of commercial surety bonds in thirty states. Most of the bonds were low penalty license and permit bonds. At renewal those bonds were re-written in Capitol Indemnity or its affiliate, Platte River. CSC has been under an Order of Rehabilitation since February 6, 2002. Included in the sale is an agreement for Capitol Indemnity to assist in the administration of the claims runoff for CSC (through the former CSC staff now employed by CIC). In addition, Capitol Indemnity subleased an office in Hartford, Connecticut and another in San Francisco, California, that were previously leased by CSC.

Effective March 31, 2002, Alleghany contributed $22 million in securities to Capitol Transamerica Corporation, which, in turn, contributed these securities to Capitol Indemnity. Also effective in the first quarter of 2002 was the contribution by Capitol Transamerica to Capitol Indemnity of its subsidiary, Capitol Specialty. This transaction made Capitol Specialty a wholly owned subsidiary of Capitol Indemnity.

Subsequent to the transactions noted above, Capitol Indemnity and Platte River, entered into an affiliated pooling arrangement, that was effective January 1, 2002, whereby first both parties cede to unaffiliated reinsurers, then Platte River's retained business is ceded 100% to CIC, then CIC cedes all business from 2002 and forward as a 10% quota share to Platte River.

Capitol Indemnity administers all aspects of the pooled business. and retains a 90% participation in the net-pooled business plus all business from 2001 and prior years.

All of the transactions and agreements mentioned above were properly filed with this office.